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Interpreting China's Fiscal Reforms and the 13th Five-Year Plan Targets

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A Three-Stage Framework for Understanding China's Fiscal Reforms ¹

To provide a starting point for understanding China's fiscal reforms, let me use a three-stage analytical framework that I developed in recent years of the country's whole open-door and reform era that started in late 1978 or early 1979.

The Reform in China has endured over three and a half decades. An important component of the country's comprehensive reform program has been the overhaul of its fiscal and financial systems. Finance underlies fundamental changes in any country's political and state systems as well as economic and social structures. To a large extent, government finance is "technical" in the sense that it is neutral regardless of the political and state systems and the economic and social structures of a country. This important feature of finance makes it an ideal forerunner of any reform efforts and a testing ground for new policies and administrative measures.

This statement is quite true of China's reform since 1979. Before any reform in the political and state system was even attempted, changes had to occur so as to provide the resources for action and incentives for individuals, groups, and entities to engage in innovation. Prior to adopting radical reforms of the economic structure or introducing new social norms, observable and unobservable adjustments emerged quietly in the means of government revenue and the ways of program outlay. After all, institutional adaptations happen gradually and incrementally; but the ways and means of government operations have to move ahead to pave the path for other aspects to evolve. This description is an accurate summary of the relationship between fiscal reforms and other reforms of China's fast-paced transition and growth so far.

In examining how these reforms unfolded and laid the foundation for other dimensions in China's systemic overhaul, a 2009 study formulated a two-stage division, according to which financial reforms in the first 15 years (1978/79-1993) were efforts mainly aimed at readjusting the country's fiscal system and those in the second 15 years (1994-2008) were aimed at introducing innovations into its fiscal system. After 2008, a third stage started. The main task of this third stage is to go deeper in overhauling the system, integrating past innovations into a network while resolving some thorny problems that were unsolvable in the past and addressing

¹ Yilin Hou (2009) formulated a two-stage framework in an article "政府职能、事权事责与财权财力—1978年以来财政体制改革的理论分析" published in 《公共行政评论》2009(2): 36-72; then he expanded the framework into three stages in his 2014 co-authored book. This section draws heavily from Hou et al. *The Property Tax in China: History, Pilots, and Prospects* (New York: Springer, 2014), Chapter 1.

new problems that have emerged with the innovations under the restraints of some persistent, old institutions.

Stage One: Readjustment for Growth and Development

Under the old, prior-1979 regime, modern government functions were not conducted properly, at least those concerning economic development and living standards were not. At the initial phase of reforms, most of the components of the old regime were very hard to break; but it was easiest to loosen the centralized management of the fiscal system. That path was natural option by China. Measures were taken on three dimensions: (1) within the government, (2) with state-owned enterprises (SOE), and (3) with individual citizens.

Regarding the first, the reform was to decentralize revenues and outlays from the center to the provinces; subsequently provinces granted more discretion and control to localities. Concerning the second, the measure was to place SOEs on job maintenance and profit contracts so as to make them fully accountable for their liability to the government, which conversely provided incentives for them to make profits for themselves. With reference to the third, the reform measure was to relieve individuals from the grips of the state so that every laborer could make their own living, and even a fortune, by working hard with their skills (workers and merchants) and means of production (farmers on collectively owned land). In urban areas, the reforms gave rise to family businesses; in rural areas, farmers got rid of the old “communes” and grew crops on their contracted land and sell produce in the market. The combination of measures in these three dimensions were the Chinese route for growth and development.

Thus, fiscal reforms first broke the ice; however, the old regime remained largely unchanged, which gave rise to new problems. One of the problems was shrinking revenue for governments, particularly central and provincial governments because lower levels of government pocketed the largest share of incremental profits from decentralization and enterprises harvested the initial benefits of the contract system. Among individuals, farmers retained the largest and best fruits of increased output (years later, however, the rural income growth lagged far behind that of urban residents). In urban areas, the self-employed became rich ahead of all others. These policy effects of “some getting rich ahead of others”² caused income disparities among the population, and the gap widened over time. A third prominent problem was the gap in growth and income between regions at both the aggregate and the individual levels. The coastal region developed earlier and faster than the interior and western regions because of their locational advantage in attracting foreign investment and cheap labor from the other, under-developed regions.

These three problems, among many others, were not treatable under the old regime or with temporary adjustments to the old regime. In a practical sense, these problems were part of the price for the “fast growth route”³ the country had chosen for itself. The problems only worsened as the country's growth accelerated and maintained momentum. Solving them would be only possible when enough wealth has accumulated to afford (finance, or allow) drastic changes and until public impatience has reached a critical point.

Stage Two: Innovations for a New Fiscal System

² This is a direct quote of Deng Xiaoping's practical strategy for development and growth.

³ This is another quote of Deng Xiaoping, 发展是硬道理 or “to grow by all means out of our current difficulties.”

In the second stage, policy innovations were introduced to build a new fiscal system in accord with the generic principles of public finance, thereby solving the problems that occurred in the first stage. In a nutshell, those problems could only be tackled by means of fiscal federalism. The goal of the new fiscal structure was to finance the opportunity for equal access to basic public services for every citizen regardless of their location of residence or type of household registration (urban versus rural). The economic and political rationale was to strive for equity between regions and income groups, thereby, to achieve and maintain social stability.

Two major policy innovations were introduced, each taking about five years to implement in this vast and populous country. The first (1994-98) adopted a separate (central versus local) tax system, under which the center collected a larger share of the major taxes (value added tax, and later, the personal income tax); provincial governments, and their localities, split the remainder of these taxes. The new tax structure provided the financial capacity for the central government to play its key roles in macroeconomic stabilization and financing public services nationwide. The second (1999-2003) established the central-local structure of fiscal transfers for basic public services and gradually increased central input into these services. Since the center collects the largest share of revenues, it naturally shall finance a large part of those services. Beginning in 2004, the new public finance structure has demonstrated substantial impacts, with annually increasing amounts of transfers for education, public health, social security, and public housing.

The new fiscal structure has also created unintended consequences that manifest as four problems. First, tax revenue is top heavy at the central level, light in the middle with provincial governments, and minimal at the bottom with local governments, whereas the responsibilities for basic service provision are laden at the bottom with localities. These two problems exist head to head. The center keeps the most resources but has the least direct responsibility; the local level has the least own-source revenue but must bear most of the burden of direct service provision. The middle level, provinces, collects some, but inadequate, own-source revenues to help out the localities; yet, they often wait for actions from the top. A third problem arises from the first two: since revenue sources and outlay responsibilities do not match, no one level can be held accountable for the less-than-desirable results. The center criticizes localities for malpractice in using the transfer funds; localities complain about the lack of resources for task overload.

Meanwhile, local officials are incentivized to fulfill all tasks set by their superior levels, because they are appointed by their bosses – thus career considerations have driven most top local officials to resort to informal, even illegal means of financing for infrastructure and development, including selling the use right of state land for cash and borrowing huge sums via local financing vehicles. The former means has been a cash cow, accounting for nearly half of the total own-source revenue in many localities for over a decade. Indeed, land sale has constituted a large amount of the input into infrastructure that has provided tangible benefits; on the other hand, land price has added considerably to the cost of new housing, which has pushed up housing prices, distorting the market and causing bitter public complaints. The latter means, hidden borrowing, has piled up long-term liabilities that in some cases are multiple times over annual local revenue. Finally, waste occurs everywhere since no one is held accountable for any specific task.

Stage Three: Towards Efficiency and Accountability

China is now situated in the third stage of its fiscal reforms with the following goals: fully addressing the major problems arising out of the second stage, establishing accountability, and

raising the efficiency of public expenditure. These reforms will by no means be easier than those in the first two stages, though resource wise, the country is much wealthier than before.

First and foremost, the goal is to refine intergovernmental fiscal relations by more closely matching outlay responsibilities with revenue sources. Specifically, this goal is intended to readjust the distribution of taxes, not necessarily to increase the overall tax-to-GDP ratio, between the layers of government thereby granting localities a reliable and stable source of revenue. Enriching the bottom level is that single piece of “stone” that can strike several birds at once: correcting the previous top-heavy revenue structure, helping to rectify distortionary local financing practices, and granting localities more autonomy.

The second goal is to re-establish the revenue-to-service link for accountability. A new source of revenue is not a free lunch for local governments; rather the money imposes a set of restrictions on the behavior of local officials. Newly added revenue is earmarked exclusively for public services, linking the new tax to specific services that have been undersupplied – education, public health, public safety, and neighborhood facilities. This revenue-to-service link will explicitly place accountability of officials into the hands of local tax payers, forcing the government to move closer to the people.

With the revenue-to-service link established, local residents/tax payers will possess a much louder voice than before in policy making. In a real sense, they have paid a tax to purchase the right of demanding the type, amount, and quality of services by revealing their preferences. This model of “public choice” for service bears support from theoretical and empirical studies in improving the efficiency of public expenditure, raising the satisfaction of tax payers, and curbing corruption. As a result, local governments will not be forced, but will strive to get closer to the people they serve.

Last, but maybe more important, such a reform of the fiscal system will help advance reforms in other aspects of the overall regime. For example, more public choice in local services plants the seed for the direct election of top local officials who are held in a reporting relationship to their voters rather than their bosses in a higher level government who appoint them. Public choice will also boost demand for free migration among the population that, in turn, will further increase competition among local governments for revenue source and ultimately high efficiency.

The core of this third stage of reforms is the real property tax as a financial means and a socio-political institution. As a financial means, the real property tax is merely a source for government revenue; but as a socio-political institution, the real property tax plays multiple roles, as previously described. This tax will serve the country well in this unfolding, deeper than ever, stage of fiscal reforms. Related to adoption of this tax will be changes to provisions about local government use of debt, which will be put on a stable, sustainable path.

No doubt, introducing and adopting an institution is never an overnight task; it may take years even decades to arrive at fruition. As I have suggested to the Chinese government in my forthcoming book,⁴ the adoption and implementation should embed a 2 to 5 year window to allow reallocation of personal and business owned real property via the real estate market.

A Note on Data Sources

⁴ Hou, Yilin et al. (2016 forthcoming) 《中国房地产税制要素设计研究》北京：经济科学出版社。

In the following, I provide my opinion as answers to the questions posed by the Commission. The sources of all data and quotes that I use are from publicly available venues. These include official and academic publications in English, and especially in Chinese for authenticity, the websites of the Chinese Central Government, the Ministry of Finance, the State Administration of Taxation, the National Bureau of Statistics, and the National Audit Office. News reports are from the official website of the Xinhua News Agency.

Question 1. China's current fiscal system; role of local governments in economic development; how local governments finance their expenditures; how land sales-based financing worked; critical reforms necessary to address the fundamental challenges of China's fiscal issues; how should the Chinese government sequence these reforms?

Q1a. Describe China's current fiscal system.

The current fiscal system of China is one with *separate central and local taxes*, that finances separate central and local functions (i.e., outlay responsibilities), with the central government transferring over 60 percent of central revenue to lower levels. In China's government structure, "local" refers to all levels below the center; thus, provinces are also called local.

This system started in 1994 as an overhaul of the old, varying subsequent versions of the *contractual revenue and outlay system* that lasted from 1978/79 till 1993 – the stage of China's Reform Program that is mainly to "break away from the prior tight-control scheme" and "to readjust for growth and development." Two typical features of the old contractual systems, as has been famously used in official documents, are two very low ratios that are taken as a symbol of low capacity of the Chinese government in raising revenue and in playing its due functions.

One ratio was aggregate government revenue against gross domestic product (GDP) – it was 24.5 percent in 1980, then continued in an annually declining mode till the lowest point of 12.3 percent in 1993. The other ratio was central government revenue against total government revenue (all levels) – it is the power of policy direction by the central government over the whole nation. This ratio was 25.5 percent in 1980; it climbed within a few years of the open-door and reform program to reach a high of 40.5 percent in 1984. But after that year, this ratio also fell into a declining mode, because the nature of the provincial contractual system was that provinces only had to submit to the center a fixed amount or ratio by pre-agreement of their increased revenues. As a result, the central-to-total revenue ratio fell to the lowest point at 22 percent in 1993.⁵

Thus, the separate-tax system of 1994 was a necessary and natural correction to the old system in order to reinstall government financial capacity, especially central government financial capacity. The means to achieve this capacity gain was to adopt the modern institutionalized taxation system rather than *ad hoc*, informal, case-by-case intergovernmental contracts. The 15 years from 1994 to 2008 was in my division the second stage of China's fiscal reforms – innovations for a new financial system.

⁵ Data source: Li Ping 李萍 *et al.* (2010) 《财政体制简明图解》 北京：中国财政经济出版社, Ch. 1.

Under the separate-tax system, those taxes that are broad and concentrated are central taxes; those that are narrow and scattered are local taxes. The major shared taxes and their split ratio between the center and provinces (in parentheses) are:

- (1) value-added tax (VAT) shared between the center (75%) and local (25%);
- (2) corporate and personal income tax shared between the center (60%) and local (40%);
- (3) business tax (varies).

By the official *Final Account* for fiscal year 2014 (the most recent fiscal year for which data are publicly available), China's National General Public Budget Revenue was 14.04 trillion RMB, or roughly 10,000 RMB per capita. Of this amount, 6.45 trillion was Central Government General Public Budget Revenue. The center, however, directly spent only 2.26 trillion of its revenue (35%); the rest (65% and higher when deficits are included) were transfers to provinces, cities, and especially counties. For FY2014, total local government general public budget revenue was 12.7 trillion, of which 5.187 trillion was tax returns and transfers from the central government.⁶

The division of outlay responsibilities between the central and local governments is relatively clear between the center and provinces: national defense, foreign affairs, monetary policy, customs, international trade, and countrywide transportation are obvious central functions. Environmental protection, public assistance, and social security are shared between the center and provinces. But the division of outlay responsibilities is infamously not clear between provinces and their lower levels that include cities (prefectures), counties, and townships.

Q1b. What is the role of local governments in economic development?

The role of local governments in economic development is widespread and substantive. In a very real sense, the Chinese government system is highly centralized in official appointments but at the same time also quite decentralized in economic development activities. Ministries and agencies of the central government control the power over regulation, resource allocation, quotas, and approval of numerous activities; these ministries and agencies, however, have to rely on the cooperation of provincial governments in implementing and achieving their policy goals. Furthermore, provincial and lower level offices of these central entities are structurally part of the local government (though some have been adjusted to follow the vertical line of order, i.e., exclusively under the central ministry and away from the so-called dual leadership regime). This complicated intertwined mixture of centralization and decentralization is a strong feature of the Chinese government and its manner of administration.

The following steps illustrate the process of development planning and implementation. First, the central government sets the country's national growth targets for each year, as specified in the country's five-year plans. Second, all major officials are appointed by their higher level governments. These appointees will by all means serve the development targets that have been set top-down – of course the goals are made through several rounds of top-down and bottom-up brainstorming and feedback collection. Third, prospects of promotion of officials depend on the growth rate of each jurisdiction or agency they are personally placed in charge of; thus, each of these officials has the constant incentive to achieve, even exceed the growth targets as has been set for their jurisdiction. This is also why the sum of prefectural annual growths exceeds the provincial growth rate and the sum of provincial annual growths exceeds that of the national

⁶ Data source: Chinese Ministry of Finance, <http://yss.mof.gov.cn/2014czys/>

growth rate. The officials' career incentive has been extremely "effective" in promoting the country's growth, which has been labeled as "GDP championship" in academic studies.⁷

Q1c. How do local governments finance their expenditures?

Under the old contractual system, local governments were able to retain large shares of their annual incremental revenues. Under the separate-tax system since 1994, local governments face persistent shortage of revenue to cover their outlays and mandates from above. Their shared revenues are mainly of the 25 percent of VAT and 40 percent of the income taxes from the shared taxes. Their own-source revenues are as of this year business taxes, some other minor local taxes, and charges and fees of various kinds. No doubt, the sale of land use rights (details in the next section) has been one dominating source in recent years, especially in developed urban areas. Another source is formal, informal, even barely legal debt that local governments have managed to obtain from state-owned banks and other commercial banks via various means.

Q1d. How has land sales-based financing worked?

By the 1982 revised *Chinese Constitution*, all urban land is the sole property of the state as represented by the central government as an abstract concept of the state.⁸ In reality though the guardianship of land-use right is at the discretion of local governments, in particular city and county governments. Before the 1994 separate-tax system was put in place, there were no issues with regard to land-use right though the actual sale of the use right first occurred in the mid-1980s in the special economic zone of Shenzhen City where a joint venture needed land for factory construction. The sale of land-use rights as a cash cow for local governments started in the late-1990s. A few years into the separate-tax system, some local officials under extreme financial pressure complained to the central government. An unprepared, spontaneous response as indirect answer to the local demand was: state land is in your control. Land sale-based financing thus started as an informal, unofficial band aid to a systemic problem that arose from the 1994 separate-tax system.

Land-use right sales started small, since few cities had done it before and no major revenue was expected from these sales. As urban development and housing provision reform started, urban land appreciated exponentially, turning land use right into a mammoth of revenue source. This financing venue works as follows. First, a local government will announce its urban development plan for a specific location for developers to bid. The land plot is put on auction, to be taken by the highest bidder. Second, the auction winner (developer) has to pay the local government in cash the land use fee. The amount of the fee is based on multiple factors. One is the length of use: 40 years for commercial and recreational use, 50 years for industrial purposes, and 70 years for residential use. Finally, the cash payment to the local government is upfront – before the start of construction, which is why the developer has to take loans from commercial banks. Then, to make a profit, the developer has every incentive to build upscale, high density projects. Thus, the payment for land use right is forward shifted into the market housing price.

⁷ The best, systematic study of this phenomenon is by Zhou Li'an 周黎安 (2010) 《转型中的地方政府：官员激励与治理》上海人民出版社。

⁸ The 1949 *Common Program* (de facto *Constitution*) and the 1954 and 1975 versions of the *Chinese Constitution* all allowed, explicitly or implicitly, private ownership of urban land.

With the collected land-use fee, local governments can afford large scale infrastructure projects. This financing mechanism has been successful to a large extent in filling in the local revenue shortage and meeting the huge demands for capital spending, which explains why and how so many cities in China have built very good airports, railway stations and other public facilities that would have taken a very long time to materialize absent of this mechanism.

The following table provides detailed data on local government revenue from sale of land use right (called “land transfer fees”) and its ratio against total local outlays for fiscal years 2008-2011 (in billions of RMB) ⁹

	2008	2009	2010	2011
Subnational general budget expenditure	49.99	63.20	74.96	94.33
Subnational fund budget expenditure	12.93	14.29	30.30	37.49
Subnational land transfer fees	10.37	13.96	29.11	33.17
Ratio (%)	16	18	28	25

We can use FY2014 figures as an example to depict the local revenue landscape: The total local own-source revenue in 2014 was 7.59 trillion. The amount of land-use right sale was budgeted for 3.43 trillion RMB; the actual sale reached 4.04 trillion. Land-sale revenue was 53 percent of total own-source revenue. Another aspect is to examine the growth of land-sale revenue: the actual for FY2014 was 17.6 percent over the budgeted amount. However, the growth over the 2013 actual amount was only 3.4 percent. ¹⁰

Q1e. In your view, what are the critical reforms necessary to address the fundamental challenges of China's fiscal issues, and how should the Chinese government sequence these reforms?

To fully address the fundamental challenges to the country's current fiscal system, the Chinese government will need to properly design and carefully implement several reforms. I list these reforms by the order that I think will be among the optimal sequence.

First, define and clarify the outlay responsibilities between central, provincial, and other local governments, especially between provincial and other local governments.

Second, readjust the revenue sources and shares of revenue split between the several layers of government according to their outlay responsibilities.

Third, central-to-local transfers will remain an important means of fiscal capacity equalization between regions of varying wealth, but own-source revenue plays a key role in tying local governments to local residents. Of this, I strongly recommend that China grant the real property

⁹ Source: Chinese Ministry of Finance, “Report on central and subnational governments' budget implementation of last fiscal year and budget of this fiscal year,” <http://www.mof.gov.cn/>. The 2015 actual amount is not yet publicly available.

¹⁰ Data source: the Ministry of Finance, http://yss.mof.gov.cn/2014czys/201507/t20150708_1269691.html

tax to city/county governments as their exclusive revenue source (not to share with higher levels) to provide key local public services.¹¹

Fourth, allow local governments to issue long-term construction bonds with their property tax revenue as collateral – tie their hands to the local tax base, and place local governments on a hard budget constraint.¹² These are not all that is needed to overhaul the current system but they are among the most crucial for ultimate success of further reforms.

Question 2. China's local government debt problem; impact of local governments' dependence on land sales and local financing vehicles on Chinese government's ability to address its misallocation of investment such as the creation of ghost towns?

Q2a. Assess the magnitude of China's local government debt problem.

There is consensus that China's local government debt has reached a very high level. Here the term "local government debt" does not refer strictly to those debts that have been issued by local governments, because the Chinese *Budget Law* does not allow local governments to issue debt; only in recent years have provincial governments officially issued some through the Ministry of Finance. The term "local government debt" refers to those debts whose ultimate liability of principal and interest payment lies with those local governments who have obtained and used, directly or indirectly, the borrowed amounts.

Since 1998, local government debt has been increasing at an annual rate of 20 percent. In 1998 the rate was 48 percent and the 2009 annual increase rate was 62 percent. The total of local government debt reached 5.48 trillion by the end of 2008; 10.72 trillion by the end of 2010; 15.89 trillion in 2012, 17.89 trillion in 2013, and 24 trillion in 2014. The interest payment by local governments on their debt in FY 2014 was 98.3 billion.¹³

Q2b. Local government financing vehicles

These include (1) sale of land use right as described in Question 1 above, and (2) various vehicles for borrowing from commercial banks. The Chinese budget law prohibits local governments from taking loans from commercial banks. To circumvent this restriction, local governments created various "financing platforms",¹⁴ whose main if not sole function is to borrow from financial institutions of all kinds on behalf of local governments. These entities may assume various names, such as corporations for city construction investment, city asset investment, urban development investment and so on. Another vehicle is for city construction corporations to issue city construction bonds.

The collateral for the loans are local government general budget revenue and state land (use right). The purpose of these loans are mostly for building bridges, urban (overhang) highways, old town renovation, and industrial parks. As of June 2013, 57 percent of local government debt was loans from commercial banks.

¹¹ For details, see Hou et al, *The Property Tax in China: History, Pilots and Prospects*. New York: Springer, 2014.

¹² Hou, Yilin and 马海涛 (2016). "中国房地产税设计原理和实施策略分析" in 《财政研究》 2016 (2).

¹³ Data sources: China State Audit Office and Ministry of Finance.

¹⁴ These are called 融资平台 in Chinese.

Q2c. How does local governments' dependence on land sales and local government financing vehicles impact the Chinese government's ability to address its misallocation of investment such as the creation of ghost towns?

The benevolent motivation and design of local government borrowing was to use these loans for infrastructure investment so as to create a favorable business environment of the locality in order to attract investment. Local governments expected that with these steps taken, the urban land under their control will appreciate, which would generate more than enough revenue through the sale of land use right for them to retire all those debts and to earn some extra.

The State Audit Office classifies local government debt into three categories:

- (1) those that the local government is liable to retire,
- (2) those that the local government is liable as guarantor, and
- (3) those that the local government is liable for some limited relief.

Of the debts that local governments are liable for repayment, 37 percent are loans with land-use right revenue as collateral.

Most of local government borrowing has been used on infrastructure, which helps lay the foundation for higher productivity growth and higher living standards. Such use of debt should be taken as a huge plus because they accumulate assets. The formation of ghost towns was a distortion of the real estate sector and the housing market by overuse of land use right that pushes housing price to the super-high region, beyond the affordability of most ordinary citizens. To address this issue, local governments should not rely on land sale as their main revenue. They should instead move to the stable, annual property tax.¹⁵

Question 3. China's existing fiscal system versus the reform agenda; changes necessary to enable a sustainable revenue stream; how will fiscal reform impact central-local government relations and the current style of economic growth? Importance of the revised Budget Law and 2017-2019 National Mid-Term Fiscal Plan; impact of recentralization of the budgeting and allocation process on China's fiscal challenges; new proposals in the 13th Five-Year Plan.

Q3a. Can China's existing fiscal system finance the reform agenda?

China's current fiscal system cannot fully finance the above-mentioned reform agenda. For one thing, the existing system is the target of reform in terms of the revenue sources and outlay responsibilities between the hierarchical layers, especially between the provincial level and their subsidiary levels. For another thing, the current revenue composition of both the central and local governments rely too heavily on indirect taxes such as the value-added tax and business taxes rather than direct taxes like the personal income tax and the real property tax.

Q3b. What changes are necessary to enable a sustainable revenue stream?

¹⁵ For details, see Hou *et al.* (2016 forthcoming) 《中国房地产税制要素设计研究》北京：经济科学出版社.

The Chinese government has already sensed, if not identified, at least some of the root causes of the problems. Mr. Lou Jiwei, the sitting finance minister is one representative. In his 2013 book, Mr. Lou clearly outlines some changes to be made. These measures include, among others:

- (1) refine the personal income tax into one with annual filing by the household of their total income, thereby converting this tax into a more equitable, redistributive instrument;
- (2) readjust the central-local fiscal transfer categories with more lump sum discretionary grants and less special purpose grants; and
- (3) channel more transfers directly to the county level in order to better secure provision of public services.¹⁶

Q3c. How will fiscal reform impact the central-local government relations and the current style of economic growth?

A more formal and systematic use of the personal income tax will help substantively improve on equity and efficiency of this tax. If, within the next few years, China can effectively implement and strictly enforce a comprehensive personal income tax so that this tax makes up a sizeable share of total tax revenue (the current share of this tax in annual total government revenue is less than 7 percent by 2013 and 2014 data), it will improve both on the horizontal and vertical equity. With strict enforcement of this tax, the overall efficiency of the economy will also improve. When the amount and share of revenue from the personal income tax substantively increases, it will be more likely that the center grants more revenue sources to the local level.

Another major reform is to design and implement a local real property tax that is to be levied on all residential, commercial, and industrial property. The revenue from this tax shall be exclusively for city and county governments to finance basic public services. An important pretext for this tax is the central and provincial governments give up their share in the multiple current taxes and fees levied on property transaction.

A third major reform is to regroup many current special purpose transfer programs into lump sum discretionary grants more directly channeled to cities and counties.

These reforms will change the landscape of central-local fiscal relations in that localities will have the financial basis to more closely follow the demands and preferences of local residents and tax payers rather than merely following the order/mandates from their higher levels.

The impact of the real property tax, as designed by me (2016 forthcoming book) will exert lasting influence on changing the paradigm of economic growth at the city/county level. By my design, cities and counties shall not collect the upfront land use fee anymore; instead these will be part of the annual property tax. Thus, the amount of land revenue will shrink substantially; local governments will rely on the stable, lasting annual property tax and annual land use fees. Economic development can be much more orderly and smooth, incremental rather than the roller coaster style of the past two decades.

Q3d. In your view, how important is the revised Budget Law? How, if at all, will recentralization of the budgeting and allocation process impact China's fiscal challenges?

¹⁶ See Lou Jiwei 楼继伟 (2013) 《中国政府间财政关系再思考》北京：中国财政经济出版社。

The first *Budget Law of China* became effective in 1995. The new *Budget Law* was passed in 2014 and became effective in January 2015. The 2015 *Budget Law* revised the old law in five major areas. The first are rules on budget management with emphasis on transparency. The total budget is composed of four parts: general public budget, governmental funds budget, state-owned assets management budget, and social insurance fund budget.¹⁷

The new law stipulates that “all revenues and outlays must be included in the government budget”, which applied the comprehensive principle of public budgeting. By this rule, the official report and account schedules on all budgeted items, adjustments, final approved amounts, and details of budget implementation should be made public by the Finance Ministry (or Department) within 20 days of approval by the People's Congress, with explanations on arrangements for transfers, implementation, and debt use.

The second area of revision is in the manner of budget control: All levels of government should create a cross-year balance mechanism and establish a budget stabilization fund in accord with related rules of the State Council for the purpose of filling in unexpected revenue shortfalls. In boom years when current revenue exceeds the budget, the extra should be placed in the stabilization fund.¹⁸

The third revision is in retaining risks of local government debt. Whereas the old law requires local governments to achieve annual balance and does not allow localities to incur any deficits, the new law imposes five specific restrictions on borrowing by local governments:

- a. Only provincial governments, with prior approval by the State Council, can incur debt;
- b. Government debt can be used only for capital outlay that produces public goods/services;
- c. The amount of debt for each province should be submitted by the State Council to the National People's Congress or its Standing Committee for approval. Each province can only borrow within the approved limit with the approval of the standing committee of the provincial people's congress;
- d. The method of borrowing can be only via issuing local government bonds, not any other means or venues; and
- e. To control risk related to and rising from local government borrowing, any issue of provincial government bonds should have a matching debt service plan and stable source of revenue for debt retirement. The State Council shall set up a risk evaluation and warning mechanism of local government debt, an emergency management mechanism, and accountability system.

The fourth major revision is in the central-local fiscal transfer system, promoting equalization between regions of varying wealth of basic public services. Transfers will consist mainly of equalization grants that are to be of discretionary use by recipient local governments. Special purpose transfers will be reassessed regularly for their necessity, with sun-set dates and with thresholds set up. Functions or services that can be effectively provided by the market should not be financed with special purpose transfers. Except cases where the State Council has explicit provision for shared vertical responsibilities, higher level governments shall not require lower

¹⁷ Some scholars in China are quite critical of this quadripartite division of the total budget. They criticize that the division violates the unity principle of public budgeting.

¹⁸ For a detailed examination of the mechanisms and effects of the budget stabilization fund, see Yilin Hou (2013) *State Government Budget Stabilization: Policy, Tools, and Impacts*. (New York: Springer)

levels to match transfers with their own-source revenue. Besides, higher levels should notify lower levels their estimates of transfer amounts ahead of local government budget preparation; all local governments should include the estimated transfers in their budget.

The fifth major revision are restraints of budget outlay to impose a hard budget constraint. These are targeted at wastes and luxuries in operation spending and office building construction, listing penalties for those to be held accountable for violations. To enforce the hard budget constraint, the new law provides that all governments are in general not to enlist new revenue sources or outlay programs during budget implementation, nor are they to seek any new revenue reduction policies or measures in the middle of the fiscal year.

In my professional judgment, these revisions are all very well intended and will exert very positive impacts on government operation in China. They are all targeted at existing problems that have been prevalent for a long time. These measures represent a great leap in public administration and government operations in China. Though it is way too early to draw any conclusions, we can predict with high certainty that these measures will over time yield huge, lasting benefits.

Q3e. In your view, how important is the (2017-2019) National Mid-Term Fiscal Plan? ¹⁹

China has been proactively exploring methods and mechanisms for fiscal stability, learning from advanced economies. The three-year mid-term fiscal plan (MTFP) ²⁰ is part of China's effort in going beyond the annual budget balance tradition toward cross-year balance in order to better handle fluctuations of the economy and financial operations. This three-year fiscal plan can be said to carry elements of the OECD mid-term expenditure framework (MTEF), transplanted into the Chinese context. The official document announcing China's adoption of this planning instrument came out in 2015 by the State Council, followed by a Ministry of Finance implementation plan at the central level. ²¹

The MTFP is a transition from annual to mid-term budget; it serves as a platform for more accurately determining revenue and outlay policies in order to achieve stable financial policy goals on the basis of scientific forecasting; the platform allows for timely adjustments in accord with socio-economic developments. The MTFP covers the four types of budgets as components of the government's total budget (general public budget, governmental funds budget, state-owned assets management budget, and social insurance funds budget). Each year's MTFP includes four parts:

- a. Forecasts major economic indicators and socio-economic status in the next three years under the existing five-year development plan and annual plan, considering major international and domestic changes in combination with base-year actual figures. Based on economic forecasts, estimate the mid-term revenues and outlays in accord with current macroeconomic policies.

¹⁹ I put the years in parentheses that came with the original question. Three-year mid-term plans are a generic financial planning tool compiled on a rolling basis, as specified in my discussion.

²⁰ It is called “中期财政规划” in Chinese.

²¹ These two documents are: “国务院关于实行中期财政规划管理的意见” (国发[2015]3号), http://www.cas.cn/gj/201501/t20150123_4303947.shtml and “财政部关于推进中央部门中期财政规划管理的意见” (财预[2015]43号) http://www.mof.gov.cn/mofhome/shenzhen/lanmudaohang/zhengcefagui/201507/t20150710_1283138.html

- b. Analyze issues with existing policies on revenues and outlays. Such issues cover:
 - (1) those on revenue sources (taxes) and their impacts on resource preservation, environmental protection, dissolution of overcapacity, income redistribution and revenue collection, as well as regulation of non-tax revenues;
 - (2) those on program outlays such as social security and healthcare, changes of these programs due to demographic changes, and the impacts of these outlays on revenue growth and outlay structure; and
 - (3) those on the risks of government debt, in particular localities where governments have incurred large amounts of debt.
- c. Compose reform plans of revenue and outlay.
 - (1) Regarding revenues, the Ministry of Finance shall consult with the Tax, Customs, and Development Ministries to propose routes and timelines for tax reform, major revenue adjustments, regulation of fees/charges, with clear policy goals and implementation schedule. These ministries should also evaluate the impact of the proposed policies on the economy, related industries, and tax burden of individuals.
 - (2) Regarding outlays, the Ministry of Finance shall consult relevant agencies to outline major reforms within the MTFP period, policies and projects of outlays, specify policy goals, list annual tasks and deadlines, with clarifications on performance measures.
 - (3) Regarding governmental debt, the Ministry of Finance shall, based on revenue and outlay and debt risk forecasts, determine appropriate scope of deficits and debt limits as risk control target. Classify debts and place them into the budget. Establish debt risk warning and emergency management mechanisms.
- d. Estimate revenues and outlays in the next three years after implementing the proposed reforms, and conduct overall balance.

All these are no doubt very useful for operation and significant as reforms. Of course, the MTFP is still a new planning tool at the current stage with its effect and benefits to be tested over time.

Q3f. Has the 13th Five-Year Plan outlined new proposals?

The 13th Five-Year Plan proposal by the Central Committee of the Chinese Communist Party outlines five broad public finance tasks.²² They are:

- a. Further the financial and tax reforms to establish modern financial infrastructure that is favorable for transforming the model of economic growth, for formulating a nationally unified market, and for promoting social equity and justice.
- b. Establish a taxation system that is scientific in tax-type composition, optimal in structure, efficient in administration, and equitable with a full set of governing rules and laws.
- c. Establish an intergovernmental relations system that matches functions with outlay responsibilities of each government level, with appropriate centralization of functions and outlay responsibilities to the central government. Better allocate the division of revenue sources between the central and local governments.

²² Data source: “中共中央十三五规划建议” made public by the Xinhua News Agency on November 3, 2015. http://news.ifeng.com/a/20151103/46094489_0.shtml

- d. Fully establish a modern, transparent public budgeting system, with cross-year balancing and mid-term fiscal plan mechanisms.
- e. Create a formal debt financing mechanism for local governments.

Linking these five overarching tasks to the analytical framework presented at the beginning of this statement, it becomes apparent that China has charted an agenda and path for its third stage of fiscal reforms. With these tasks accomplished, the country's fiscal structure will have mounted a higher platform for smooth development and growth.

Question 4. Assess the progress of fiscal reforms. How successful, thus far, has the Chinese government been in increasing transparency, reining in debt, and strengthening accountability? How effective have these reforms been at lowering the debt burden for local governments and addressing the current gap in revenues and expenditures?

A lot of progress has been made in the fiscal reforms and measures that I have discussed in response to the previous questions. The new *Budget Law of China* that was promulgated in 2014 and became effective in January 2015 lists transparency as one major target. Progress in this area is evidenced by the online availability of numerous budget documents and financial reports of various ministries at the central level and of most provincial governments. Furthermore, increasing transparency is not only common in coastal areas where the reform programs are very advanced but also in inland and western provinces where sophisticated reform ideas have also taken deep root.

The success in reining in debt, however, is hard to assess. At least, we can say that though the central government has implemented harsh administrative measures and exerted political (within the Party) pressure, it will not be easy to reduce debt that has already been incurred. The reason is clear: the structural friction in revenue and outlay responsibilities between higher levels and cities/counties has not been fully addressed. The current strict measures can help restrain the momentum of debt increase at best until the systemic issues have been solved.

The anti-graft campaign since 2013 within the Communist Party has been successful in deterring rampant corruption; most senior officials and offices at all levels have begun to follow the formal rules rather than disobey rules or apply the informal rules. Still, it is hard to conclude that accountability has substantially improved. In other words, the full benefit of the anti-graft movement takes time to yield economic benefits; but no doubt it is one important step.

The “new normal” of economic development that targets medium high growth rates (for example, the 6.5 to 7.0 percent rate for FY2016, even the 7.0 percent annual rate for the 12th five-year plan period) is/was an important step towards lowering the pressure for local governments to incur more debts for the purpose of boosting development. An even more important and effective measure in this regard is to give up each locality's annual GDP growth rate as the performance measure of top local leaders.

A current reform that has just been announced at this year's session of the National People's Congress that adjourned in mid-March is to reduce tax rates, thereby lessening the tax burden on businesses and taxpayers (the so-called “supply-side reform”). One part of this is to convert some categories of the old “business taxes” into the value-added tax – the VAT automatically deducts the input by the lower-stream firms whereas the business tax does not allow deduction.

For local governments, the share they get from the newly converted VAT is 50 percent rather than 25 percent as in the 1994 split on the VAT. It is too early to draw conclusions about the effects of these most recent reforms, though some experts in China hold reservations about the tax reduction claim.

Question 5. How is the Chinese government attempting to restructure local government debt, and how effective have these policies been? What is the importance and effectiveness of China's reissuance of the provincial bond system, debt-for-bonds swaps, and debt-for-assets/debt-for-equity swaps? How, if at all, does China's New-Type Urbanization Plan and land reforms impact China's fiscal policies? What other policies are under consideration in order to restructure local government debt and create new revenue streams?

Most of local government debt has been invested in local infrastructure including public facilities and industrial parks; some debt was guaranteed for local state-owned enterprises.

Provincial bonds are a relatively new policy that was started several years ago. The bond issuance is typically done by the Ministry of Finance on behalf of provincial governments; the annual total amount has not been large, on average each province got several billion at most, which is far from enough to cover the huge gap between revenue and outlay of local governments.

Thus, most of the existing local government debt was taken out under the name of the various "financing platforms" mentioned earlier. The most recent initiatives such as "debt-for-bonds swaps", "debt-for-assets" or "debt-for-equity swaps" are all designed to alleviate the tremendous imminent pressure on local governments to pay back their loans to financial institutions. This type of debt swaps was used in the late-1990s under Premier Zhu Rongji to facilitate the transformation of state-owned enterprises ahead of China's entry to the World Trade Organization. That round of swaps was to a large extent successful in that state banks were able to wipe out their bad loans so that their account books looked good; the bad assets were separated from the banks into the hands of four asset management corporations created specifically for that purpose (each corresponding to one state-owned commercial bank then). Later, these asset management corporations were able to make a profit due to China's entry into the WTO deal and the boom of the real estate sector and the housing market.

This current round of swaps have not yet been fully launched. The mechanisms will be the same as with the 1990s round: local governments and their affiliated industrial parks and supported enterprises will not go bankrupt, the financial institutions that had loaned to local governments will not have to bear the bad or dead loans on their balance sheet. So, in the immediate- and short-term, the loan-to equity swaps may turn out to be a win-win for both creditors (banks) and debtors (local governments). But in the medium- and long-term, it is hard to say whether both sides will win, because the swaps do not solve the root cause to bad loans. Furthermore, the swaps transfer the financial uncertainty from local governments (debtors) to the financial institutions (creditors) who are good at making fixed-term investments but are poor at managing assets and businesses. However, since the swaps grant local governments some breathing time, the hope by the central government is that the debt-ridden local state-owned enterprises will return to profitability within a short period of time. If this bright prospect does not happen, then the financial uncertainty now hanging over the banks may turn into a systemic financial collapse.

Question 6. Tax reforms by the Ministry of Finance and State Administration of Taxation to boost revenues; viability of value-added, property, resource, and personal income taxes; impact of property tax on local government revenues; will the expansion of the value-added tax to real estate, financial, and consumer services affect the drivers of economic growth?

Q6a. What tax reforms have the Ministry of Finance and State Administration of Taxation undertaken to boost revenues (e.g., VAT, property, and resources)?

The new measures, not necessarily as formal as reforms, that the Ministry of Finance and the State Administration of Taxation have taken since last year (2015) to boost revenue are mainly administrative rather than any new taxes. The Chinese government has become accustomed to double digit revenue increases each year, at a higher rate than the growth of GDP. Therefore, since late 2014 when the New Normal, i.e., slower economic growth became the norm, a much more serious dilemma facing the government is the drastically slowed down growth of tax revenue. Since 2015, the Ministry of Finance and the State Taxation Administration have been working to enforce collections in an effort to boost revenue. The reason for this dilemma is that the slower growth creates higher demand for services, meaning the government at all levels will have to spend more. This is a typical countercyclical outlay picture. So far it is hard to say how effective the revenue boosting measures have worked.

Beginning from this year, the State Council has been emphasizing the expansion of the value added tax to several sectors that used to be subject to the business tax. This effort has been labeled as tax reduction for businesses in an effort to boost the economy. Thus, we have seen opposite directions from last year to this year, which is an indication that the government is facing hard choices, with deficits rising for sure.

Q6b. What is the viability of value-added, property, resource, and personal income taxes?

The value-added tax has been used in China since the mid-1990s, with a relative mature structure of tax administration and enforcement. This tax in general has been successful as an efficient major revenue source despite many cases of tax evasion and tax receipt fakes.

There remains a long way to go with regard to the personal income tax. The Ministry of Finance has outlined a clear map for turning this tax into a major revenue source, which it is yet to be. There are many reasons behind the very low ratio of the personal income tax in the total revenue. An important one is the heavy, widespread use of the informal economy, grey income, and fringe benefits that do not count into the tax base. In the past several years, China has made a lot of progress in widening the tax base. As of now, the PIT-total revenue ratio is still below 10 percent.

The real property tax as of now remains one on commercial property. The one on residential property was piloted in Shanghai and Chongqing since 2011, more as a signal than as a serious tax because the base for the two pilot programs is very small. Thus, the real property tax is not a viable revenue source.

The first version of the Chinese resource tax was started in 1984 to adjust the differential profit gap between stages of production and distribution. It was levied as an *ad valorem* tax on

petroleum, natural gas, coal and so on, but not on metallic and nonmetallic minerals. Beginning from 1994, this tax was expanded to cover all minerals plus salt; the levy was changed to a fixed amount by production volume. Over the years there has been a hot debate about this tax between mining firms, local governments, and tax/finance authorities, each side highlighting their own arguments.

In mid-2009, during the depth of the financial crisis, hundreds of mining companies petitioned in unison to the Ministry of Land and Natural Resources pressuring against the resource tax, claiming that the tax was dragging economic recovery. Around the same time, the Chinese coal sector association suggested to postpone universal levy of the tax. The National Development and Reform Commission stated explicitly that a market price system of energy that recovers externality costs is the first step toward the target of resource preservation and omission reduction. Near the end of the year, a State Council document clearly stated to expedite resource tax reform and to improve the center-local allocation ratios of the resource tax.²³

In general, the Ministry of Finance, the State Energy Agency, and the State Taxation Administration have since the end of 2009 repeatedly expressed opinions that the resource tax reform would be coming soon. A May 2010 circular of the State Council even said that the resource tax would start within the year.²⁴ One task listed in Premier Li Keqiang's 2016 Government Work Report is to spread price-based resource tax levy to the whole country.²⁵

From the *Final Account of the 2014 National Budget*, we see that the resource tax was budgeted at 120.8 billion but collected only 89 percent of the expected amount (108 billion).

Q6c. How would the property tax impact local government revenues?

The real property tax will exert huge and lasting impacts on local government revenues if it is levied on all properties, in particular residential property. But as of now there has been a lot of deeply rooted opposition to the tax, together with misleading policy recommendations by tax experts and think tanks. My design of the tax scheme is universal levy with a tax burden reduction mechanism to achieve horizontal and vertical equity in order to minimize loopholes and efficiency loss. Specifically, it is to exempt an amount of the house value that is the product of the number of household members, one-third of the local average housing space, and the median market price of housing per square meter.²⁶

Q6d. How will the expansion of the value-added tax to real estate, financial, and consumer services affect the drivers of economic growth?

From March to now this year, the State Tax Administration has repeatedly emphasized, with strong support from Premier Li Keqiang that the VAT expansion will not add, but only reduce the tax burden on businesses and households on their housing transactions.

²³ For details, see 《国务院办公厅关于应对国际金融危机保持西部地区经济平稳较快发展的意见》(November 4, 2009): 加快推进资源税改革, 进一步完善矿产资源补偿费中央与地方的分配关系。

²⁴ See 国务院批转发改委《关于2010年深化经济体制改革重点工作的意见》(May 31, 2010)

²⁵ See the whole report at http://www.gov.cn/guowuyuan/2016-03/17/content_5054901.htm

²⁶ For details, see Hou *et al.* (2016, forthcoming) 《中国房地产税制要素设计研究》北京: 经济科学出版社。

Question 7. What other policies is the Chinese government pursuing to raise revenues? How successful have these efforts been? What proposals are currently under consideration?

Since 2013, the main economic policy in China has been deregulation and decentralization, or the supply-side measures, as the concerted efforts to boost the economy. The theme of the December 2015 Central Economic Conference, as specified in the Government Work Report by Premier LI Keqiang to the National People's Congress in early March this year, can be summed up as five tasks. The following table lists the tasks and provides the most recent data of the first quarter of 2016:²⁷

Task	2016 Quarter 1 performance
(1) Reducing excess production capacity of steel and coal	Raw steel -3.2%; coal -5.3%
(2) Reducing stock of newly developed housing and industrial products	Housing sales: floor space +30%; volume +50% Products: +0.7%
(3) Reducing leverage (January and February)	Industrial firms: 56.8% (0.1% lower from last year same period)
(4) Lowering taxes and fees on businesses (January and February)	Cost down by -0.29 per 100 RMB of industrial revenue
(5) Making up the short-board: invest more, especially in targeted areas	+20% in infrastructure like power, communications, and urban facilities

The Chinese Minister of Finance and Central Bank Governor at the Washington, D.C. G-20 annual financial officials meeting revealed China's first quarter performance in these areas;²⁸ Director of State Statistics Bureau also announced specific figures in these areas.²⁹ Overall, the indicators are positive, reflecting the efforts the Chinese government has made since last year.

Instead of increasing revenue, the Chinese government is incurring more deficits for fiscal year 2016, at 2.18 trillion or 3 percent of GDP, which is 560 billion over the deficit level of FY2015. Of the total deficit, 1.4 trillion is for the central budget and the remaining 780 billion for local budgets.³⁰ By a most recent inter-ministry plan, reducing the excess production capacity in the steel and coal industries will displace 1.8 million workers whose placement (many to retire early) will add a huge burden on government finances. The Premier made the public announcement in his annual work report (March) that "government at all levels are to tighten their belts, to spend each sum on a touchable item for substance."

²⁷ Data source: China National Bureau of Statistics, <http://www.stats.gov.cn/>

²⁸ The *Wall Street Journal* (mid-April) covered these details during the 2016 G-20 Financial Officials D.C. Meeting.

²⁹ Details are made public via the Xinhua News Agency, http://news.xinhuanet.com/fortune/2016-04/19/c_128911090.htm

³⁰ Data source: Chinese Premier's annual government work report in early March to the National People's Congress, http://www.gov.cn/guowuyuan/2016-03/17/content_5054901.htm

Question 8. The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. Assess the implications of China's on-going fiscal reforms and 13th Five-Year Plans for United States. What are your recommendations for Congressional action related to the topic of your testimony?

China's on-going and planned fiscal reforms as well as those fiscal reforms outlined in China's 13th Five-Year Plan display several important signals. First, there exist many huge distortions in the country's economic system and government financial structure; these distortions were accumulated residuals from previous reforms that relied on extensive, expansionary models of development for the country to achieve very high GDP growth. Under this perspective, the double digit growths were remarkable accomplishments; on the other hand, extraordinary expansions necessarily left behind a heavy trail of inefficiencies, distortions that have become increasingly heavier drags on the economy. Therefore, the so-called "new normal" of 6.5% to 7% annual growth rate is only natural; it is much more fitted with the development and current status quo. It will be very hard, if not impossible, to resume the previous double digit growths. In other words, even if double-digit growth is doable again, the Chinese government would probably opt not to resume that high pace, for the simple reason that the ultimate cost is too high. The New Normal's annual growth target is already reasonably high, for sustainable development.

Second, the series of fiscal reforms are headed in the right direction. Higher reliance on direct taxes like the personal income tax and real property tax will better address wealth inequality and increase the overall economic efficiency of the whole society and economy. Deregulation of the old, rigid grips by the government of businesses and individuals will boost innovation and productivity. Decentralization and readjustment to the intergovernmental fiscal relations will grant provinces and other local governments more discretion and hold them accountable to citizens, free them from GDP championship that had caused the overhang of mammoth local government debts. No doubt, none of the above reforms are easy; thus, the Chinese government faces many challenges in the coming years.